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THE LORANDA GROUP, INC.

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The Loranda Group, Inc. is a diversified agricultural services firm headquartered in Springfield, Illinois. The company offers personalized, professional services in agricultural real estate brokerage, auctions, acquisitions, and consulting. Land Facts *is published periodically. We welcome your comments and questions, or give us a call if you would like to discuss the farmland market in your particular area.*

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What Can Stop the Land Market Locomotive?

by John D. Moss, President

Think back with me to a time when most people had never heard of a "tax-deferred exchange." A time when it was difficult to sell a farm at almost any price, and a wide variety of properties simply sat on the market. For those under the age of 40, it's something that you've read about but probably never experienced. Yes, those were the mid 80's. In contrast, for the past 15 years the land market has been traveling down a very different one-way track. And during these 15 years, the question that I have been most asked is "how much longer can prices continue to rise?"

In order to answer this question, one must determine what specific factors have been fueling the market strength, and then decide if there will be any changes in these factors that will significantly affect either the supply of land available for purchase or the demand for land from farmers or investors interested in expanding their portfolios. In looking back over the past 15 years, it's interesting to note that even though land prices have consistently increased each year, there has not been any one major driving force fueling the trend for the entire time period. Instead, we've seen a number of underlying causes. Let's take a look back to see how we got to where we are today:

1988–1993 When the declining farm real estate values finally reversed course and started moving higher in 1988, the main driver was higher grain prices. The drought of 1988 reduced the supply of corn and soybeans, which ultimately led to an increase in commodity prices, an increase in farm income, and more importantly an increase in farmers' confidence that the worst farm crisis since the 1930's was nearly over. With confidence comes a willingness to take on additional risk—

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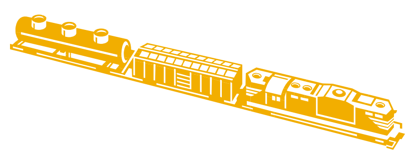
often in the form of a land purchase. Interest rates were still fairly high relative to today's rates, and there were very few investors in the market looking for trade properties.

1993–1998 During the mid 1990's, farm income was becoming more stable, interest rates were beginning to come down, and from the supply side there were substantially fewer foreclosed properties on the market. These "forced liquidation" properties had been a drag on land prices for several years. With fewer tracts available to buy and more people interested in purchasing, it was inevitable that land prices would continue moving higher. In retrospect, this was the time period when the upward trend was most at risk. One major agricultural consultant boldly predicted in 1993 that a major *drop* in land prices was inevitable—"at these higher prices, land won't cash flow." His statement was true—land rarely pays for itself—but his prediction was false. While the cash flow generated by a farm is an important component in determining value, it's not the *only* value driver.

1998–2003 Over the past 5 years, some new factors have helped fuel farmland prices. Undoubtedly the most important is the emergence of the tax-deferred exchange buyer. The Internal Revenue Service has permitted exchanges for a long time, but it's only been in the past few years that this group of buyers has become large enough to significantly alter land prices. These individuals are motivated by more than just the annual return on their farmland investment. They are driven by a desire to avoid (or at least delay) paying a substantial capital gains tax on land that they are typically selling for development. The increase in the shear number of these buyers can be attributed to the strength of the general economy and low interest rates, which have propelled commercial and residential development to never-before-seen levels. Low interest rates have also made borrowing costs cheaper for land buyers, thus allowing them to pay more for a parcel of land. Finally, the new farm bill enacted in 2002 has lent support to farmland prices. Essentially, a floor has been established that can help protect farm income levels for the next several years. The combination of all these factors have kept the land market locomotive on track to record price levels in many parts of the Midwest.

2003–2008 It is tempting to look at our current record-high land prices and predict an imminent collapse, similar to what we observed with technology stocks. However, I personally don't see any weakness in prices for the next couple of years. As mentioned previously, the government program has given farmers some confidence in their income prospects. And with confidence comes risk-taking and high dollar purchases —that's why the government and the stock market always pay close attention to consumer confidence surveys. I only see three potential changes on the horizon that could de-rail the current value trend: (i) a significant rise in interest rates; (ii) additional cuts in the capital gains tax rate; and (iii) a collapse in housing prices. Regarding interest rates, it is inevitable that rates will start moving higher in the near future. A 1 to 2 % increase does not concern me. However, a 3 to 4 % increase would. With a large jump in rates, borrowing costs for all real estate buyers would increase. Commercial and residential development would slow, and consequently, the number of tax-deferred exchange buyers would decline as well. Regarding a further reduction in the capital gains tax rate, though the cut earlier this year was substantial, it still was not enough to slow the number of 1031 exchanges (please see accompanying article). If Congress should decide to cut the rate below 10%, then more people will pay the tax and take their cash versus completing a trade. Finally, with respect to housing prices, a few economists believe that the housing market is a balloon ready to burst. In some major cities (e.g., Atlanta, GA), too much new construction has created an overbuilt situation and home prices have fallen. Though I don't necessarily see this happening in the Midwest, the possibility does exist. If the market becomes saturated, then new development will cease and tax-deferred exchange buyers will not be active land market participants.



In summary, at least for the next 24 months, I cannot see any major reason why the market *won't* remain firm. New laws can change the landscape at any time. And the lower annual returns associated with higher land prices may discourage some people from entering the market, and motivate some people to exit the market and pocket their appreciation. I would watch interest rates carefully and be prepared to act should a major change occur.

The Impact of the Capital Gains Tax Rate Reduction on Land Prices

Earlier this year, Congress announced with great fanfare a reduction in the tax rate on long-term capital gains. On the surface, it appeared that this reduction could have an impact on land prices—sellers would pay the tax instead of making a land trade. However, in reality the effect of the law change has been minimal.

So why wouldn't a 25% cut in the tax rate, from 20% to 15%, motivate more individuals to simply cash out of their real estate investment? Because in real dollar terms, even a 15% tax can be substantial. For example, we recently sold a client's farm for $1.2 million. Since the land had been purchased very cheaply in the 1950's, the tax basis was only $200,000. Under the old law, the $1 million gain would have created a federal tax liability of $200,000, had the seller taken the proceeds in cash. Under the new law, the seller would be paying less, but would still have to write a check to the federal government for $150,000, along with another check to the state government. For most sellers, this is still too much money to part with, especially with the availability of the 1031 tax-deferred exchange. This is why trade buyers are still willing to pay a premium for land in today's market. And why the reduction from 20% to 15% sounds better than it really is.

The Reavis Farm Real Estate Auction:

A Case Study in "Selling History"

In late July, The Loranda Group had the distinct pleasure of auctioning 424 acres in Gibson County, Indiana owned by the heirs of William A. Reavis. This property was more than just tillable land and wooded land—it had a unique history which provided both an opportunity and a challenge with respect to its marketing.

William Reavis arrived in Gibson County in 1817 on horseback, just a year after Indiana was granted statehood. Shortly after his arrival, the Wabash and Erie Canal was built, and it ultimately crossed the farm that was auctioned. This canal was to provide an inexpensive mode of transportation for goods being shipped from the Upper Midwest. Though quite active in the mid 1800's, the canal system was soon replaced by the railroad as the preferred means of shipping. The July auction included one of the only remaining sections of the canal.

The property was ultimately divided into 16 tracts to appeal to farmers, investors, home site buyers, and groups interested in preserving the canal. While the intentions of most historical groups are noble, in some cases their dreams are much greater than their pocketbooks. In this specific auction, the preservationists were expecting the 22-acre canal to be donated to their group and were considering a campaign to discourage other would-be buyers from bidding on the canal. The property owners were not opposed to the goals of the historical groups but wanted fair market value for their land. And the fairest way to determine the value for a man-built waterway over 150 years old is to offer it in an open and competitive market at auction.

After two hours of active bidding, the entire property sold for $1.185 million, or nearly $300 per acre above pre-sale estimates. The canal tract was purchased by a local individual for $55,000. His goal is to restore the structure to its original condition for all in the area to enjoy. In reality, the goals of all parties were met through the auction process—the sellers received a fair price for their property, and the canal will be restored and treasured for its historical significance.

The Real Estate Corner

Welcome to a new feature in *Land Facts*—"The Real Estate Corner." Whether you are a buyer or seller, we hope that the information provided will benefit your understanding of the real estate market. Many of the terms and issues that will be discussed here may already be familiar to you. But our hopes are that we can shed some light on some of the "whys" behind the "whats" that involved in a typical real estate transaction.

Offer

In most states, an offer must be in writing to be legal and binding upon both parties. This doesn't mean a sale can't be consummated without a written contract. It simply means that either party can walk away from an oral contract at any time. As a result, you don't want to get too excited about that great verbal offer on your property. It's not really valid or meaningful until it is put to writing.

Counter-Offer

Once a seller has received a written offer, they have three choices. First, they can *accept* the offer as written, and upon signing the contract it will be binding on both parties. Second, they can *reject* the offer outright with no further negotiations. Or third, they can make a *counter-offer*. Keep in mind that as soon as a change is made in the original offer, regardless of how insignificant it may be, the original offer is no longer binding. Don't think that if the buyer doesn't accept your counterproposal, then you can automatically fall back to the terms and conditions in the original offer. The buyer *may* be willing to do that, but they have no obligation to do so and may walk away. Also realize that a buyer can revoke their offer at any time, even before it officially expires. Even though you're ready to accept the buyer's offer, if they revoke it before you sign it, then you have no recourse. Just like an offer, all counter-offers must be in writing and signed by both parties.

Deed

This is the document used to convey title from seller to buyer. Ideally, a seller will provide a general warranty deed. This type of deed provides the buyer with the greatest protection of any type of deed as the seller is warranting good clear title to the property. Other types of deeds commonly used include a special warranty deed, where the seller warrants or guarantees the title only against defects arising during the period that the seller has owned the property; and a quit-claim deed, where the seller makes no warranties or guaranties at all— they are simply conveying what ever interest they may have in the property.

Abstract of Title

This document is basically a condensed history of the title to a particular parcel of real estate from the original grant, along with all subsequent conveyances and encumbrances affecting the property. A few states, like Iowa for example, still use abstracts of title in conjunction with an attorney's opinion of title as a means for the buyer to learn about the real estate they are purchasing.

Title Insurance

Title insurance is a policy that insures the owner or mortgagee against loss by reason of defects in the title to a parcel of real estate, other than encumbrances, defects, and matters specifically excluded by the policy. Most buyers believe that a general warranty deed provides enough protection against possible title defects. Unfortunately, if the seller dies or is not aware of defects in the title, then their warranties may not be worth much. The best protection a buyer can have when purchasing a parcel of land is a title insurance policy. Interestingly, a quit claim deed along with a title insurance policy offers more protection for a buyer than a general warranty deed without title insurance.

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for current real estate listings and upcoming auctions: **www.loranda.com**